

CHAPTER 40
DETERMINATION OF NET INCOME

[Prior to 12/17/86, Revenue Department[730]]

701—40.1(422) Net income defined. Net income for state individual income tax purposes shall mean federal adjusted gross income as properly computed under the Internal Revenue Code and shall include the adjustments in 40.2(422) to 40.9(422). The remaining provisions of this rule and 40.12(422) to 40.69(422) shall also be applicable in determining net income.

This rule is intended to implement Iowa Code section 422.7.

701—40.2(422) Interest and dividends from federal securities. For individual income tax purposes, the state is prohibited by federal law from taxing dividends from corporations owned or sponsored by the federal government, or interest derived from obligations of the United States and its possessions, agencies, and instrumentalities. Therefore, if the federal adjusted gross income of an individual, taxable by Iowa, includes dividends or interest of this type, an adjustment must be made by deducting the amount of the dividend or interest. If the inclusion of an amount of income or the amount of a deduction is based upon federal adjusted gross income and federal adjusted gross income includes dividends from corporations owned or sponsored by the federal government, or interest derived from obligations of the United States and its possessions, agencies, and instrumentalities, a recomputation of the amount of income or deduction must be made excluding dividends or interest of this type from the calculations.

A federal statute exempts stocks and obligations of the United States Government, as well as the interest on the obligations, from state income taxation (see 31 USCS Section 3124(a)).

“Obligations of the United States” are those obligations issued “to secure credit to carry on the necessary functions of government.” *Smith v. Davis* (1944) 323 U.S. 111, 119, 89 L.Ed. 107, 113, 65 S.Ct. 157, 161. The exemption is aimed at protecting the “borrowing” and “supremacy” clauses of the United States Constitution. *Society for Savings v. Bowers* (1955) 349 U.S. 143, 144, 99 L.Ed.2d 950, 955, 75 S.Ct. 607, 608; *Hibernia v. City and County of San Francisco* (1906) 200 U.S. 310, 313, 50 L.Ed. 495, 496, 26 S.Ct. 265, 266.

Tax-exempt credit instruments possess the following characteristics:

1. They are written documents,
2. They bear interest,
3. They are binding promises by the United States to pay specified sums at specified dates, and
4. They have Congressional authorization which also pledges the faith and credit of the United States in support of the promise to pay. *Smith v. Davis*, supra.

A governmental obligation that is secondary, indirect, or contingent, such as a guaranty of a non-governmental obligor’s primary obligation to pay the principal amount of and interest on a note, is not an obligation of the type exempted under 31 USCS Section 3124(1). *Rockford Life Ins. Co. v. Department of Revenue*, 107 S.Ct. 2312 (1987).

The following list contains widely held United States Government obligations, but is not intended to be all-inclusive.

This noninclusive listing indicates the position of the department with respect to the income tax status of the listed securities. It is based on current federal law and the interpretation thereof by the department. Federal law or the department’s interpretation is subject to change. Federal law precludes all states from imposing an income tax on the interest income from direct obligations of the United States Government. Also, preemptive federal law may preclude state taxation of interest income from the securities of federal government-sponsored enterprises and agencies and from the obligations of U.S. territories. Any profit or gain on the sale or exchange of these securities is taxable.

40.2(1) Federal obligations and obligations of federal instrumentalities the interest on which is exempt from Iowa income tax.

a. United States Government obligations: United States Treasury—Principal and interest from bills, bonds, and notes issued by the United States Treasury exempt under 31 U.S.C. Section 3124[a].

1. Series E, F, G, H, and I bonds
2. United States Treasury bills
3. U.S. Government certificates
4. U.S. Government bonds
5. U.S. Government notes

b. Territorial obligations:

1. Guam—Principal and interest from bonds issued by the Government of Guam (48 USCS Section 1423[a]).

2. Puerto Rico—Principal and interest from bonds issued by the Government of Puerto Rico (48 USCS Section 745).

3. Virgin Islands—Principal and interest from bonds issued by the Government of the Virgin Islands (48 USCS Section 1403).

4. Northern Mariana Islands—Principal and interest from bonds issued by the Government of the Northern Mariana Islands (48 USCS Section 1681(c)).

c. Federal agency obligations:

1. Commodity Credit Corporation—Principal and interest from bonds, notes, debentures, and other similar obligations issued by the Commodity Credit Corporation (15 USCS Section 713a-5).

2. Banks for Cooperatives—Principal and interest from notes, debentures, and other obligations issued by Banks for Cooperatives (12 USCS Section 2134).

3. Farm Credit Banks—Principal and interest from systemwide bonds, notes, debentures, and other obligations issued jointly and severally by Banks of the Federal Farm Credit System (12 USCS Section 2023).

4. Federal Intermediate Credit Banks—Principal and interest from bonds, notes, debentures, and other obligations issued by Federal Intermediate Credit Banks (12 USCS Section 2079).

5. Federal Land Banks—Principal and interest from bonds, notes, debentures, and other obligations issued by Federal Land Banks (12 USCS Section 2055).

6. Federal Land Bank Association—Principal and interest from bonds, notes, debentures, and other obligations issued by the Federal Land Bank Association (12 USCS Section 2098).

7. Financial Assistance Corporation—Principal and interest from notes, bonds, debentures, and other obligations issued by the Financial Assistance Corporation (12 USCS Section 2278b-10[b]).

8. Production Credit Association—Principal and interest from notes, debentures, and other obligations issued by the Production Credit Association (12 USCS Section 2077).

9. Federal Deposit Insurance Corporation (FDIC)—Principal and interest from notes, bonds, debentures, and other such obligations issued by the Federal Deposit Insurance Corporation (12 USCS Section 1825).

10. Federal Financing Bank—Interest from obligations issued by the Federal Financing Bank. Considered to be United States Government obligations (12 USCS Section 2288, 31 USCS Section 3124[a]).

11. Federal Home Loan Bank—Principal and interest from notes, bonds, debentures, and other such obligations issued by any Federal Home Loan Bank and consolidated Federal Home Loan Bank bonds and debentures (12 USCS Section 1433).

12. Federal Savings and Loan Insurance Corporation (FSLIC)—Principal and interest from notes, bonds, debentures, and other such obligations issued by the Federal Savings and Loan Insurance Corporation (12 USCS Section 1725[e]).

13. Federal Financing Corporation—Principal and interest from notes, bonds, debentures, and other such obligations issued by the Federal Financing Corporation (12 USCS Section 2288(b)).

14. Financing Corporation (FICO)—Principal and interest from any obligation of the Financing Corporation (12 USCS Sections 1441[e][7] and 1433).

15. General Services Administration (GSA)—Principal and interest from General Services Administration participation certificates. Considered to be United States Government obligations (31 USCS Section 3124[a]).

16. Housing and Urban Development (HUD).

- Principal and interest from War Housing Insurance debentures (12 USCS Section 1739[d]).
- Principal and interest from Rental Housing Insurance debentures (12 USCS Section 1747g[g]).
- Principal and interest from Armed Services Mortgage Insurance debentures (12 USCS Section 1748b[f]).
- Principal and interest from National Defense Housing Insurance debentures (12 USCS Section 1750c[d]).
- Principal and interest from Mutual Mortgage Insurance Fund debentures (12 USCS Section 1710[d]).

17. National Credit Union Administration Central Liquidity Facility—Income from notes, bonds, debentures, and other obligations issued on behalf of the National Credit Union Administration Central Liquidity Facility (12 USCS Section 1795k[b]).

18. Resolution Funding Corporation—Principal and interest from obligations issued by the Resolution Funding Corporation (12 USCS Sections 1441[f][7] and 1433).

19. Student Loan Marketing Association (Sallie Mae)—Principal and interest from obligations issued by the Student Loan Marketing Association. Considered to be United States Government obligations (20 USCS Section 1087-2[1], 31 USCS Section 3124[a]).

20. Tennessee Valley Authority—Principal and interest from bonds issued by the Tennessee Valley Authority (16 USCS Section 831n-4[d]).

21. United States Postal Service—Principal and interest from obligations issued by the United States Postal Service (39 USCS Section 2005[d][4]).

22. Treasury Investment Growth Receipts.

23. Certificates on Government Receipts.

40.2(2) Taxable securities. There are a number of securities issued under the authority of an Act of Congress which are subject to the Iowa income tax. These securities may be guaranteed by the United States Treasury or supported by the issuing agency's right to borrow from the Treasury. Some may be backed by the pledge of full faith and credit of the United States Government. However, it has been determined that these securities are not direct obligations of the United States Government to pay a specified sum at a specified date, nor are the principal and interest from these securities specifically exempted from taxation by the respective authorizing Acts. Therefore, income from such securities is subject to the Iowa income tax. Examples of securities which fall into this category are those issued by the following agencies and institutions:

a. Federal agency obligations:

1. Federal or State Savings and Loan Associations
2. Export-Import Bank of the United States
3. Building and Loan Associations
4. Interest on federal income tax refunds
5. Postal Savings Account
6. Farmers Home Administration
7. Small Business Administration
8. Federal or State Credit Unions
9. Mortgage Participation Certificates
10. Federal National Mortgage Association
11. Federal Home Loan Mortgage Corporation (Freddie Mac)
12. Federal Housing Administration
13. Federal National Mortgage Association (Fannie Mae)
14. Government National Mortgage Association (Ginnie Mae)
15. Merchant Marine (Maritime Administration)

b. Obligations of international institutions:

1. Asian Development Bank
2. Inter-American Development Bank
3. International Bank for Reconstruction and Development (World Bank)

c. Other obligations:

Washington D.C. Metro Area Transit Authority

Interest from repurchase agreements involving federal securities is subject to Iowa income tax. *Nebraska Department of Revenue v. John Loewenstein*, 514 US —, 130 L.Ed.2d 470, 115 S.Ct. — (1994). *Everett v. State Dept. of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991).

For tax years beginning on or after January 1, 1987, interest from Mortgage Backed Certificate Guaranteed by Government National Mortgage Association (“Ginnie Maes”) is subject to Iowa income tax. See *Rockford Life Insurance Company v. Illinois Department of Revenue*, 96 L.Ed.2d 152.

For the treatment of interest or dividends from regulated investment companies (mutual funds) that invest in obligations of the type discussed in this rule, see rule 701—40.52(422).

This rule is intended to implement Iowa Code section 422.7.

701—40.3(422) Interest and dividends from foreign securities, and securities of state and their political subdivisions. Interest and dividends from foreign securities and from securities of state and their political subdivisions are to be included in Iowa net income. Certain types of interest and dividends, because of specific exemption, are not includable in income for federal tax purposes. To the extent such income has been excluded for federal income tax purposes, unless the item of income is specifically exempted from state taxation by the laws or constitution of Iowa or of the United States, it must be added to Iowa taxable income.

The following is a noninclusive listing of bonds issued by the state of Iowa and its political subdivisions, interest on which is exempt from both federal and state income taxes.

1. Board of Regents: Bonds issued under Iowa Code sections 262.41, 262.51, 262.60, 262A.8, and 263A.6.
2. Urban Renewal: Bonds issued under Iowa Code section 403.9(2).
3. Municipal Housing Law - Low-income housing: Bonds issued under Iowa Code section 403A.12.
4. Subdistricts of soil conservation districts, revenue bonds: Bonds issued under Iowa Code section 467A.22 (transferred to Iowa Code section 161A.22 in 1993 Iowa Code).

5. Aviation authorities, revenue bonds: Bonds issued under Iowa Code section 330A.16.
6. Rural water districts: Bonds and notes issued under Iowa Code section 357A.15.
7. Iowa Alcoholic Beverage Control Act - Warehouse project: Bonds issued under Iowa Code section 123.159.
8. County Health Center: Bonds issued under Iowa Code section 331.441(2)“c”(7).
9. Iowa Finance Authority, Sewage treatment and drinking water facilities financing: Bonds issued under Iowa Code section 220.131(6) (transferred to Iowa Code section 16.131(6) in 1993 Iowa Code).
10. Agricultural Development Authority, Beginning farmer loan program: Bonds issued under Iowa Code section 175.17.
11. Iowa Finance Authority, Iowa comprehensive petroleum underground storage tank fund: Bonds issued under Iowa Code section 455G.6(14).
12. Iowa Finance Authority, E911 Program notes and bonds: Bonds issued under Iowa Code section 477B.20(6). (Transferred to Iowa Code section 34A.20(6) in 1993 Iowa Code.)
13. Quad Cities Interstate Metropolitan Authority Bonds: Bonds issued under Iowa Code section 330B.24. (Transferred to Iowa Code section 28A.24 in 1993 Iowa Code.)
14. Iowa Finance Authority, Municipal Investment Recovery Program: Bonds issued under Iowa Code section 220.173(4). (Transferred to Iowa Code section 16.173(4) in 1993 Iowa Code.)
15. Prison Infrastructure Revenue Bonds: Bonds issued under Iowa Code section 16.177(8).
16. Government Flood Damage Program Bonds: Bonds issued under Iowa Code section 16.183(4).
17. Iowa sewage treatment bonds: Bonds issued under Iowa Code section 16.131(6).
18. Community college residence halls and dormitories bonds: Bonds issued under Iowa Code section 260C.61.
19. Community college bond program bonds: Bonds issued under Iowa Code section 260C.71(6).
20. Regents institutions medical and hospital buildings at University of Iowa bonds: Bonds issued under Iowa Code section 263A.6.
21. Interstate bridges bonds: Bonds issued under Iowa Code section 313A.36.
22. Iowa higher education loan authority: Obligations issued by the authority on or after July 1, 2000, pursuant to either division of Iowa Code chapter 261A as authorized in Iowa Code section 261A.27.
23. Vision Iowa program: Bonds issued on or after July 1, 2000, upon request of the vision Iowa board pursuant to subsection 8 of Iowa Code section 12.71.
24. Honey Creek premier destination park bonds: Bonds issued under Iowa Code Supplement section 463C.12(8).
25. Iowa utilities board and Iowa consumer advocate building project bonds: Bonds issued under 2006 Iowa Acts, chapter 1179, section 70.

Interest from repurchase agreements involving obligations of the type discussed in this rule is subject to Iowa income tax. *Nebraska Department of Revenue v. John Loewenstein*, 514 US —, 130 L.Ed. 2d 470, 115 S.Ct. — (1994). *Everett v. State Dept. of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991).

For the treatment of interest or dividends from regulated investment companies (mutual funds) that invest in obligations of the type discussed in this rule, see rule 701—40.52(422).

Gains and losses from the sale or other disposition of bonds issued by the state of Iowa or its political subdivisions, as distinguished from interest income, shall be taxable for state income tax purposes.

This rule is intended to implement Iowa Code sections 12.71, 261A.27, and 357A.15; Iowa Code Supplement section 463C.12 as amended by 2006 Iowa Acts, chapter 1004, section 3; and Iowa Code Supplement section 422.7 as amended by 2006 Iowa Acts, chapter 1179, section 71.

701—40.4(422) Certain pensions, annuities and retirement allowances. Rescinded IAB 11/24/04, effective 12/29/04.

701—40.5(422) Military pay.

40.5(1) Rescinded IAB 6/3/98, effective 7/8/98.

40.5(2) For income received for services performed prior to January 1, 1969, and for services performed for tax periods beginning on or after January 1, 1977. An Iowa resident who is on active duty in the armed forces of the United States, as defined in Title 10, United States Code, Section 101, shall include all income received for such service performed prior to January 1, 1969, and for services performed during tax periods beginning on or after January 1, 1977. However, the taxability of this active duty military income shall be terminated for any income received for services performed effective the day after either of the two following conditions:

a. When universal compulsory military service is reinstated by the United States Congress. “Compulsory military service” is defined to be the actual act of drafting individuals into the military service and not just the registration of individuals under the Military Selective Service Act (50 App. U.S.C. 453); or

b. When a state of war is declared to exist by the United States Congress.

Federal active duty does not include a member of the national guard when called for training by order of the governor through order of the adjutant general. These members are in the service of the state and not on active duty of the United States. Federal active duty also does not include members of the various military reserve programs. A taxpayer must be on active federal duty to qualify for exemption. National guard and reservists who undergo voluntary training are not on active duty in a federal status. National guard and reservist pay does not qualify for the military exemption and such pay is taxable by the state of Iowa.